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IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

20TH CENTURY INSURANCE CO., *et al.*,
Petitioners,

v.

JOHN GARAMENDI, Insurance Commissioner
of the State of California,
Respondent.

On Petition For A Writ of Certiorari to the Supreme Court of California

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RESPONDENT' S BRIEF IN OPPOSITION

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QUESTION PRESENTED

Whether a one-year rate order yielding a 10% return on equity effects an unconstitutional confiscation of property.

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20th CENTURY INSURANCE CO., *et al.*,
Petitioners,

v.

JOHN GARAMENDI, Insurance Commissioner
of the State of California,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE SUPREME COURT OF CALIFORNIA

Respondent John Garamendi, Insurance Commissioner of the State of California, respectfully urges the Court to deny the petition of 20th Century Insurance Company, *et al.* ("Pet."), seeking review of the decision of the Supreme Court of California in *20th Century Insurance Co. v. Garamendi*, 8 Cal. 4th 216, 878 P.2d 566, 32 Cal. Rptr. 2d 807 (1994).

INTRODUCTION

20th Century Insurance Co. and its affiliate (collectively "20th Century") seek review of a unanimous decision of the California Supreme Court, upholding a one-year rate order adopted by Respondent Commissioner pursuant to Proposition 103, the voter-adopted insurance-reform measure. The order directs 20th Century, which enjoyed a 31.5% rate of return on its statutory equity in 1989, (App. 287a n.27), to refund 12.203% of its 1989 premiums, (App. 34a). The

refund, which permitted the company to earn a 10% return for that year, effectively rolled the company's rates back to the level that prevailed one year before enactment of regulation. (App. 34a.)

To overturn this unremarkable application of the established jurisprudence on temporary rate orders, 20th Century asks this Court to declare that it was *constitutionally entitled* to a one-year rate of return of *at least 20%*.

Petitioners pin their claim to such an entitlement not on the need to pay dividends (which could easily be paid out of the 10% authorized profit), not on the need to service debt (the company had none), not on the need to raise funds in the capital markets (like most insurers, 20th Century relied on retained earnings and had no need to raise outside capital in 1989). (App. 272a, 288a.) Rather, to support their claim, Petitioners fabricate a new constitutional right: the entitlement to rates to support the pre-regulation value of the company. Respondent submits there is no such right; the law has long been clear the Constitution is not offended by a regulation that may merely diminish a firm's value.

Petitioners lack not only a coherent legal theory but also a record to support their claim. In an attempt to establish that 10%—which was above the industry average profit in 1989 and equal to the industry rate of return for the preceding decade—was "confiscatory," they tendered opinion testimony rejected by the trier of fact as being theoretically flawed, premised on unrealistic assumptions, inconsistent with historical observation, and not credible.

To devise a "conflict" between the decision below and various other cases, Petitioners ignore the holding of the California Supreme Court—that a 10% rate of return is not confiscatory—and instead impute to that court the opinion that there is no constitutional right to a profit at all. That is not what the court held. Indeed, it is exactly contrary to what the same court previously held, when it specifically

limited the Proposition 103 rollbacks to the extent necessary to give insurers the opportunity to earn a fair return.

The unanimous California Supreme Court has now rejected both extremes, holding that insurers are constitutionally entitled to a reasonable profit but not constitutionally entitled to immunity from regulation. Neither decision conflicts with established authority. There is no need for this Court to exercise its certiorari jurisdiction.

STATEMENT OF THE CASE

Before 1988, insurance rates in California were unregulated. On November 8, 1988, California voters responded to sharply rising premiums by enacting Proposition 103, replacing the laissez-faire system with strict regulation of rates and with other measures to increase competition in insurance markets.

To correct the accreted effects of regulatory neglect and anticompetitive practices, Proposition 103 mandated a one-year rollback on all rates charged in the initiative's first year, to 20% below the rates that prevailed a year before enactment. Cal. Ins. Code § 1861.01(a) (West 1993). In *Calfarm Insurance Co. v. Deukmejian*, 48 Cal. 3d 805, 771 P.2d 1247, 258 Cal. Rptr. 161 (1989) ("*Calfarm*"), the California Supreme Court upheld the 20% rollback and one-year freeze against facial attack, but held that under *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) ("*Hope*"), the insurers were entitled to have the rollback reduced to a lesser amount if necessary to avoid confiscation.

In response, some 460 insurers filed 4,089 applications for exemption from the one-year rollbacks. (App. 34a.) Faced with the enormous task of ruling on so many applications for rollback exemptions, plus the permanent responsibility of reviewing all future rates, Respondent Insurance Commissioner John Garamendi adopted regulations prescribing the formula he would use to calculate whether the full 20% rollback would be confiscatory as to each company and,

if it would, what lesser amount could constitutionally be ordered. Cal. Code Regs. tit. 10, §§ 2641.1-2645.9 (1994) (partially reprinted at App. 377a-399a).

The California regulations specified how each company's operating results should be calculated, based on its own costs and revenues, *id.* §§ 2641.3, 2644.1-2644.23, 2645.3-2645.9, prescribed the maximum reasonable expense levels, *id.* §§ 2444.9-2644.12, 2645.5, and authorized a 10% return on equity for the rollback year, *id.* § 2645.6.[1] The 10% was found reasonable upon expert testimony that it represented the lower bound of returns a 1989 investor might expect in the property-casualty insurance industry, that it was comparable to returns of other industries with similar risks, and that 10% was the industry-average rate of return for the ten years ending in 1989. (App. 90a-95a.)

In adopting the regulations, Respondent Commissioner noted that insurance companies employ a wide variety of bookkeeping methods, which can portray the results of a company's operations in widely different ways. He therefore found that a single, consistent methodology for reviewing rates was necessary to ensure fundamental fairness and to make the administrative burden manageable. (App. 377a at § 2643.1.)

On October 16, 1991, the Commissioner issued an order to 20th Century Insurance Company and its 21st Century affiliate, convening a hearing on their rollback liability. The order contained the Commissioner's preliminary determination that the full 20% rollback would not permit 20th Century to earn a fair return under the *Calfarm/Hope* test and instead ordered 20th Century to show cause why a 13.3378% refund should not be required. (App. 224a.)

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[1]The rollback-year rate of return was set at the bottom of the range of reasonable returns. *Id.* §§ 2645.2, 2645.6. After the rollback year, the regulations permit the insurer to earn a return anywhere in the range of reasonable returns. *Id.* §§ 2644.15-2644.16.

In the hearing that followed, 20th Century, which by its own admission enjoyed a 31.5% return on statutory equity in 1989, (App. 287a n.27), contended that it could not constitutionally be ordered to refund any amount, that any rollback would be confiscatory. (*See* App. in Cal. S. Ct. at 9003-9007.) The company challenged the common methodology, urging alternative formulations of its operating results. (App. 225a-253a, 269a-301a.) Resisting the notion that it could be held to an industry-wide 10% authorized rate of return, 20th Century argued it had a right to a rate of return no less than its "cost of capital," which the company's witness put at various levels over a 20% return on equity.

On May 8, 1989, Respondent issued his final administrative decision, further reducing 20th Century's rollback obligation from the preliminary calculation, to 12.203%, plus interest. (App. 34a.) In effect, the order merely rolled 20th Century's rates back to their level one year before passage of the initiative, nullifying a rate increase the company took before its rates would become regulated.[2]

Petitioner appealed to the Superior Court, which struck down the regulations and the rollback order on various state- and federal-law grounds. The California Supreme Court reversed, unanimously upholding the regulations and the 20th Century rollback order against all challenges. (App. 1a-133a.) Rehearing was likewise unanimously denied, (App. 214a), and this appeal ensued.

REASONS TO DENY THE WRIT

Petitioners seek a writ of certiorari to establish a remarkable new principle of law: that a firm whose rates are regulated is constitutionally guaranteed rates that yield a profit equal to that firm's pre-regulation cost of capital each

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[2]To be precise, the adjudicated rollback rate was 98.89% of the company's November 8, 1987, rate, or a 1.11% reduction. (App. 34a.)

and every year of rate regulation. In so doing, the petition seeks nothing less than to sweep away a century of this Court's jurisprudence.

As it happens, even if the Court were inclined to entertain Petitioners' argument, it could not do so on this record. Petitioners' central assumption—that they were denied their cost of capital—was rejected by the trier of fact, who found Petitioners' evidence on their cost of capital neither credible nor persuasive.

Neither Petitioners' unprecedented legal theory nor the evidentiary record justifies certiorari review of the California Supreme Court's decision.

I. Petitioners Fabricate a False "Conflict" by Mischaracterizing the Decision Below and Ignoring Its Holding.

Petitioners repeatedly argue with the decision below for its treatment of the wholly hypothetical circumstance of a rate order with no allowance for profit. Yet 20th Century's rate order did not deny it a profit. The order explicitly provided for a 10% return in 1989.[3] (App. in Cal. S. Ct.

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[3]The petition materially misstates the record on the 10% return realized by 20th Century. Petitioners aver that "while the California Supreme Court stated that 20th Century's permitted rate of return was 11 percent, *id.* at 126a, the Commissioner himself calculates it at approximately 8 percent." (Pet. at 18.) The cited authority for this proposition is pages 82-83 of the Commissioner's opening brief in the California Supreme Court. The cited figure is *not* the calculation of the realized rate of return, but rather the yield realized by 20th Century on its own investments (the income on reserves and surplus the company holds and invests), contrasting the 10% authorized rate of return with "the investment yield—in 20th Century's case . . . 8.01-percent investment yield . . . ." (Appellant's Opening Br. at 82-83.)

The 8% figure to which Petitioners refer is nonetheless relevant here. It shows that 20th Century was earning only 8% on its own investment portfolio at the same time the Commissioner was authorizing it to earn

(continued...)

at 11262-11287.) That figure is actually *above* the industry-average rate of return for the year in question, and equal to the industry average for the ten years ending in that year. (App. 27a.)[4]

Thus, it is important to bear in mind what the court *actually held* in this case: that a rate order limiting 20th Century's profit for a single year to a 10% rate of return did not constitute confiscation of the insurer's property. The company had made no effort to demonstrate that the refund would have any deleterious effect on its ability to continue to operate successfully or to attract and maintain capital, but had instead staked its claim of confiscation on the naked assertion that it was constitutionally entitled to at least a 20% return on equity. No case, of course, has ever suggested that a firm was constitutionally entitled to a return of that magnitude, much less so when the supporting evidence consisted solely of discredited manipulation of econometric

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[3](...continued)
10% on its insurance business. The comparison is additional evidence that the authorized rate of return is reasonable.

[4]In another misleading citation to the record, Petitioners assert that "the unrebutted record evidence shows that for 1989 . . . the average cost of capital for the insurance industry was approximately 16 percent." (Pet. at 18 (citing App. 93a).) The rulemaking record before the agency contains the Commissioner's consideration and rejection of that "unrebutted record evidence." It consisted of industry witnesses' manipulations of the financial models, yielding results that, for the preceding ten years, estimated the industry's cost of capital fully seven percentage points higher than the industry's actual returns. (App. 284a-285a.) When confronted with the divergence of their theory and hard history, the industry response was, in effect, that history is broken: A ten-year record of actual returns below theoretical claims merely proves that the industry chronically disappointed its investors. (App. in Cal. S. Ct. at 32120.)

models of the returns hypothetical investors would hope to realize under unregulated conditions.[5]

Given the manifest reasonableness and consistency with prior precedent of the California Supreme Court's actual holding below, it is understandable that Petitioners should attempt to portray the decision as authorizing a no-profit rate order. Bereft of any case finding authorization of the industry-average rate of return to be confiscatory, Petitioners necessarily range beyond the holding below to fabricate a purported "conflict," accusing the court of establishing "a new test for confiscation." The decision did no such thing, and the asserted "conflict" is one solely of Petitioners' own making, based on their misreading of the term "cost of capital" as used in the various opinions they cite.[6]

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[5]Indeed, one would be hard-pressed to find any case in which any firm has ever been authorized a 20% rate of return—even as a matter of regulatory largesse, much less as a matter of constitutional compulsion.

[6]The notion of a conflict between Petitioners' cited authorities and the decision below subsumes yet another of their false assumptions: that the law of confiscatory *utility rates* governs regulation of insurance rates in a voluntary market where there has been no dedication of property. In fact, the question of confiscation is not even implicated where an enterprise is not required to participate in the regulated market. *Bowles v. Willingham*, 321 U.S. 503, 517 (1944) (rent control act did not effect taking because "there is no requirement that the apartments in question be used for purposes which bring them under the Act"); *Whitney v. Heckler*, 780 F.2d 963, 972 (11th Cir. 1986) ("It is well established that government price regulation does not constitute a taking of property where the regulated group is not required to participate in the regulated industry"); *Garelick v. Sullivan*, 987 F.2d 913, 916 (2d Cir. 1993) ("A property owner must be legally compelled to engage in price-regulated activity for regulations to give rise to a taking."); *Burditt v. Department of Health & Human Servs.*, 934 F.2d 1362, 1376 (5th Cir. 1991) (no taking where service providers "voluntarily accept responsibilities" under challenged statute); *Minnesota Ass'n of Health Care Facilities, Inc. v. Department of Pub. Welfare*, 742 F.2d 442, 446 (8th Cir. 1984) (voluntary decision to participate in regulated market "forecloses the possibility

(continued...)

There is no conflict between the California Supreme Court's decision and the established case law. The decision below quotes extensively from *Hope* and its progeny, faithfully applying the constitutional principles embodied in those decisions. In particular, the decision below is consistent with prior cases in recognizing the regulated firm's entitlement to its "capital costs," by which the cases refer to the actual payment of interest obligations and dividends. Thus, as Petitioners' favorite passage makes clear, *Hope* viewed "capital costs" in terms of servicing obligations to existing holders of the company's securities:

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. *Cf. Chicago & Grand Trunk R. Co.* v. *Wellman*, 143 U.S. 339, 345, 346[ ]. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.

Hope, 320 U.S. at 603 (quoted wholly or in part in Pet. at 11, 19, 24). As the California Supreme Court pointed out, *Hope* assigns these factors to "the investor or company point of view," not to the constitutional minimum. But for present purposes, the significant observation is that "capital costs"—like the other "operating expenses"—were in the nature of current payment obligations.

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[6](...continued)
that a statute could result in an imposed taking"). Since 20th Century is voluntarily participating in the California insurance market, without any dedication of its property and without any utility obligation to meet any and all future demand, the constitutional principles of the utility cases are inapposite.

That is decidedly *not* what these insurers talk about when they use the term "cost of capital," and not what Petitioner 20th Century claimed it had been denied. To the insurers, cost of capital is not a measure of obligations to current holders of the company's securities, but enticements to prospective future lenders and stock purchasers to invest in the company on terms favorable to its present owners. Were that what *Hope* was addressing, it would not have spoken about the need "to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." Financial *integrity* sounds in solvency, not in degree of profitability. Financial integrity and the ability to attract capital can be assured at widely varying profit levels. Lower profit does not preclude attraction of capital, it merely yields the current holder of securities less advantage. If this Court intended in *Hope* to create a constitutional issue in choosing from among different profit levels, all of which preserve the company's integrity and access to capital, it presumably would have specified that the attraction of capital must occur at the current market value—and would have acknowledged the established authority it was thereby overruling.

Petitioners' perspective on cost of capital turns not on present owners' obligations but on potential future owners' *expectations*. Those expectations, reflected in the market price of the security, are the product of what investors foresee for the company, including, naturally, their expectation of regulatory policies. When Petitioners argue that "cost of capital" is the fixed star around which regulated rates must rotate, they argue that the Constitution prohibits the disappointment of prospective future investors, including their regulatory expectations.[7]

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[7]Because they make investor expectations into a constitutional standard, Petitioners promote the study of investor psychology to an issue of constitutional litigation. Divining investor expectations is, of course, (continued...)

None of which is to say that investor expectations ought not to be considered, nor whether, in a given case, the regulator ought to strive to increase or decrease the company's value. That is always a regulatory issue.[8] It has never before been a *constitutional* issue.

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[7](...continued)
an imprecise art, scarcely the stuff of constitutional factfinding. Indeed, nowhere has the speculative nature of this inquiry been more vividly illustrated than in this very case. The agency decision summarizes how fanciful 20th Century's economic "evidence" of cost of capital was:

> Stiglitz's [20th Century's economist witness] prefiled testimony purported to support rates of return ranging between 35.51 and 47.41 percent. Moreover, in his prefiled testimony, he suggested that these rates should be multiplied by 2.08 to adjust for the regulations' use of SAP rather than GAAP as the accounting basis, producing rates of return ranging from 74 to 99 percent a year! However, on the witness stand Stiglitz disavowed the 2.08 multiplier that he had advocated in his prefiled testimony, most likely because by then [20th Century's] SAP-to-GAAP adjustment theory had already been discredited by the Department's evidence that SAP and GAAP returns for 20th Century were within one percent of each other in 1989—a fact conspicuously missing from the company's prefiled evidence.
>
> The extreme variations in the rate of return numbers that Stiglitz sponsored at different times on the issue of the rate of return required to avoid confiscation seriously undermines the credibility of his testimony. After abandoning the 2.08 multiplier, he testified variously that: 41.5 percent was "a good starting point"; that even with potential errors in his testimony "the lowest I could come to would be 20 percent"; and that the number was no less than 28 percent. He finally lighted on 33 percent.

(App. 285a-286a (record citations and footnote omitted).)

[8]Again, this very case illustrates the fact. After 20th Century's severe losses in the 1994 Northridge earthquake, (*see* Pet. at 11 n.4), the Commissioner authorized a rate increase for the company, in part to aid its efforts to raise additional capital.

Given the ethereal nature of Petitioners' constitutional test, there is considerable irony in their criticism of the California Supreme Court's decision as lacking standards. In fact, once it is recognized that the "capital costs" of *Hope* are fundamentally different from their investor-psychology test, application of the *Hope* standard is relatively straightforward: Does the rate so impair the company's ability to service its debt and to pay dividends that the company will be "shut off from" capital? *Jersey Central Power & Light Co. v. Federal Energy Reg. Comm'n*, 810 F.2d 1168, 1181 (D.C. Cir. 1987). Only under such conditions of "deep financial hardship," *id.*, can a rate order rise to the level of confiscation.

The wording of *Jersey Central*—which Petitioners appear to dismiss as some kind of linguistic lapse—makes eminent sense once the "capital costs" at issue are acknowledged. Regulatory action merely causing the firm to lose a part of its value in the market does not "shut off" the firm from capital markets, does not inflict a "deep financial hardship," and does not raise constitutional concerns. But impairing its ability to service its debt and to raise capital *at all* does, indeed, threaten to deny it the opportunity to "operate successfully," potentially requiring constitutional protection of the firm that has been compelled to dedicate its property to public service and has assumed a legal obligation to build plant and acquire equipment to meet future demands.[9]

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[9]The capital costs of constitutional dimension also explain the temporal issue in the takings jurisprudence. Even denial of the ability to service debt and pay dividends may not effect a taking if it is only for a sufficiently short time, precisely because an occasional interruption of profit is common in business and typically will not preclude access to capital markets in the future. On the other hand, the word "temporary" may not always insulate a rate order from constitutional scrutiny, if its effects are so profound as to threaten the firm with deep financial hardship and permanently to imperil its ability to operate successfully. Of course, 20th Century presented no evidence that a one-year limitation to a 10% profit would have any effects of comparable moment.

Recognizing this distinction between Petitioners' concept of "cost of capital" and what the courts have long viewed to be the constitutionally significant "capital costs" of an enterprise vaporizes the "conflict" Petitioners purport to see in the cases. The California Supreme Court's decision certainly does not conflict with Judge Bork's opinion for the court in *Jersey Central*, which repeatedly emphasized that a rate order could not be deemed confiscatory if its "end result" constituted "a reasonable balancing" of "the consumer interest in being charged non-exploitative rates" and "the investor interest in maintaining financial integrity and access to capital markets." 810 F.2d at 1178.[10] The rate order at issue there, through its refusal to include in the rate base the unamortized portion of the utility's prudent investment in an abandoned nuclear power plant, was alleged to have left the firm in such financial distress that it had been unable to pay any dividends for four years and was shut off from long-term capital. *Id.* at 1181. That is precisely the condition that the California Supreme Court explained *would* amount to confiscation, because the rate would not allow the regulated firm to "operate successfully." (App. 82a.) Conversely, it is far from the circumstance that 20th Century claimed to be in as a result of the Commissioner's refund order.

Nor does the decision below conflict with any of the other cases cited by Petitioners. For example, the New Jersey Supreme Court's decision in *State Farm Mutual Auto Insurance Co. v. New Jersey*, 124 N.J. 32, 590 A.2d 191 (1991), considered petitioner State Farm's facial takings challenge to certain surtaxes and assessments imposed by the state's Fair Automobile Insurance Reform Act, which

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[10]The decision in *United States v. FCC*, 707 F.2d 610 (D.C. Cir. 1983), also cited by Petitioners, likewise characterizes the investors' interest under *Hope* as ensuring that the utility is able to cover the actual costs of its business. *See id.* at 612 (revenue must be sufficient "not only to cover operating expenses but also to pay for the capital costs of doing business, including service on debt and dividends on stock").

prohibited the insurers from passing the new charges directly through to insureds. In rejecting the insurers' assertion that the additional costs of the new charges "will necessarily restrict carriers to a negative, or a break-even, or only a minimally positive return," and that the Act was therefore "a confiscatory taking," 590 A.2d at 201, the New Jersey court described the applicable constitutional standards in terms identical to those used by the California Supreme Court in *Calfarm* and in the decision below. After noting that "the precise applications of the legal standards [governing confiscation] must differ according to the characteristics of particular regulated industries," *id.* at 199, the court explained:

> [T]he constitutional requirement that a business be permitted a return sufficient to assure its financial health does not necessarily require any particular level of profit above what is adequate to attract and retain invested capital. "Regulation may, consistently with the Constitution, limit stringently the return recovered on investment, for investors' interests provide only one of the variables in the constitutional calculus of reasonableness." In price regulation, consideration of the investors' interests must be counterbalanced by consideration of the consumers' interests.

Id. (citations omitted).[11]

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[11]The *State Farm* opinion also quoted from the New Jersey Supreme Court's earlier description of the constitutional standards in *Hutton Park Gardens v. Town Council*, 68 N.J. 543, 570, 350 A.2d 1 (1975):

> The rate of return permitted need not be as high as prevailed in the industry prior to regulation nor as much as an investor might obtain by placing his capital elsewhere. . . . Determination of what level of return is "just and reasonable" involves evaluation not only of the interests of the investor but also of the interests of the consumer and of the general public sought to be advanced by the regulatory legislation.

Similarly, the California Supreme Court's decision does not conflict with the Ninth Circuit's decision in *Guaranty National Insurance Co. v. Gates*, 916 F.2d 508 (9th Cir. 1990). The Nevada rollback statute at issue in *Gates* was held to be facially unconstitutional because it could not be interpreted to permit insurers to charge rates high enough to cover both their operating expenses and "the capital costs of the business . . . , includ[ing] the service of the debt and dividends on the stock." *Id.* at 515 (quoting *Hope*). Because the court in *Gates* read the statute to make *no* allowance for a return beyond the recovery of actual losses and expenses, the regulated firms would have been unable to pay any dividends or interest, leaving them without the means of raising capital or retaining earnings to support their insurance operations.[12]

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[12]The other cases cited by Petitioners as purportedly conflicting with the California Supreme Court's decision here are no more availing. Many do not raise or even advert to the constitutional standard of confiscation at all. *E.g.*, *Attorney Gen. v. Department of Pub. Utils.*, 392 Mass. 262, 467 N.E.2d 72, 75 (1984) (Attorney General challenging order allowing gas rate increase "conceded at oral argument that he presents no constitutional . . . basis" for claim); *Mountain States Tel. & Tel. Co. v. Department of Pub. Serv.*, 191 Mont. 331, 624 P.2d 481 (1981) (upholding Commission's allowance of 10.01% rate of return on utility's rate base); *Appeal of Ch shire Bridge Corp.*, 126 N.H. 425, 493 A.2d 1151, 1158 (1985) (upho.ding rate order because utility had not carried its "burden to prove that the commission's order precludes it from raising the money necessary for the proper discharge of its public duties). Others simply parrot *Hope*'s general description of the investors' interest in covering "the capital costs of the business, including service on the debt and dividends on the stock." *E.g.*, *Hastings v. Village of Stowe*, 125 Vt. 227, 214 A.2d 56, 61 (1965); *see also New England Tel. & Tel. Co. v. Department of Pub. Utils.*, 327 Mass. 81, 97 N.E.2d 509, 516 (1951) (utility has "the right to earn a sufficient return to maintain its credit and to obtain additional capital when needed to enable it to serve its public"). And none purport to analyze the constitutional standard for confiscation to any degree, but merely establish a company-specific rate of return for a particular utility based upon the record compiled before the administrative agency. *E.g.*, *Alabama Power Co. v. Alabama Pub.*

(continued...)

By contrast, there is no question on this record that the challenged rate order does not interfere with 20th Century's ability to meet its capital costs as that term is used in the cases. The company had no debt in 1989, and its dividend yield was a meager 1.95%. (App. 288a.) The authorized 10% rate of return left it fully able to meet those capital costs and then some.

In ruling on petitions for certiorari, the Court does not look for interesting abstract principles and does not review the dicta of lower courts. Whether the California Supreme Court would have upheld a rate order leaving an insurer with no profit may once have been an interesting question, but it is not the question implicated by these petitions.[13] The holding of the California Supreme Court was that a rate order *yielding a 10% return* is not confiscatory. Theoretical speculation about whether different courts would reach different results when confronted with a 0% rate order cannot be resolved on this record.

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[12](...continued)
Serv. Comm'n, 422 So. 2d 767 (Ala. 1982) (rate that does not reflect the actual returns utility would earn during period rates would be in effect and which prevents company from obtaining needed capital is confiscatory); *Appeal of Pub. Serv. Co. of N.H.*, 130 N.H. 748, 547 A.2d 269, 271, 274 (1988) (utility should receive rate of return sufficient "to maintain its credit, to pay a return to the owners of the enterprise, and to insure the attraction of capital in amounts adequate to meet future needs," but "utility has no constitutional right to returns commensurate with 'highly profitable or speculative ventures'" (quoting *Bluefield Co. v. Pub. Serv. Comm'n*, 262 U.S. 679, 693 (1923))).

[13]And, of course, it is a question that has already been answered. The California Supreme Court *has* already ruled on a rollback that leaves the insurer no profit. It held the resulting rate confiscatory in *Calfarm*.

II. Petitioners Would Have This Court Hold That Regulation May Not Diminish the Value of a Regulated Firm.

The crux of Petitioners' argument is the extraordinary claim that a rate order authorizing a rate of return lower than the company's pre-regulation "cost of capital"[14] is ipso facto confiscatory.

Although Petitioners resist the fact, this argument is nothing less than a back-door attempt to construct a new constitutional principle: that government regulation may not reduce the value of a regulated firm. That principle could only be erected by first tearing down over a century of case law that no modern court has even questioned.

"Cost of capital," as used by Petitioners, is not a static quality of a firm, but rather a measure of the firm's current value to potential investors. A firm's cost of equity capital simply refers to the price its shares will fetch in capital markets. The brighter its prospects for future profits, the higher investors will value its stock, the more they will pay for it, and the lower the firm's cost of capital. In the case of a publicly-traded company, its day-to-day market price is simply the market's consensus about the firm's prospects for profit. If some event (of which regulatory action is but one example) causes the market to view the firm's prospects less favorably, the price of its stock will fall. That establishes its

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[14]Although Petitioners phrase the issue in terms of the authorized rate of return being "below the company's cost of capital," that terminology invites confusion. The company's "cost of capital" is the cost the company must "pay" to raise capital—i.e., the amount of equity its present owners would have to give up to raise a given increment of new capital. The argument is that the potential investors implicitly assume a given return on their invested capital, and that if they posited a lower return they would pay less for the equity, causing the stock price to drop. So Petitioners' objection is actually that the authorized rate of return is lower than they claim *investors* would require in order for them to be willing to pay the *current* price for the stock.

new cost of capital. Viewed most charitably, 20th Century is claiming that its authorized rate of return was less than investors would require to maintain its pre-regulation stock price. Even if such claims were true and investors required a greater rate of return in order to maintain the stock price, the company would not lose its ability to attract capital; it would merely have access under terms less favorable to the current owners of its equity. At rates of return lower than 20th Century demanded, its stock would not be worthless; rather, its stock would only be worth less.

Petitioners cannot avoid the fact that their theory lies in complete contradiction of established authority. It is expressly repudiated by the case all parties acknowledge to be the foundation of constitutional jurisprudence on rate regulation, *Hope*, which was explicit on the point: "[T]he fact that value is reduced does not mean that the regulation is invalid." 320 U.S. at 601. Cases stretching roughly 50 years on either side of *Hope* have said the same. *E.g.*, *Concrete Pipe & Prods., Inc. v. Construction Laborers Pension Trust*, ___ U.S. ___, 113 S. Ct. 2264, 2291 (1993) ("our cases have long established that mere diminution in the value of property, however serious, is insufficient to demonstrate a taking" (citing *Euclid v. Ambler Realty Co.*, 272 U.S. 365, 384 (1926); *Hadacheck v. Sebastian*, 239 U.S. 394 (1915))); *Andrus v. Allard*, 444 U.S. 51, 66 (1979) ("loss of future profits . . . provides a slender reed upon which to rest a takings claim"); *Bowles v. Willingham*, 321 U.S. 503, 517 (1944) ("Of course, price control, the same as other forms of regulation, may reduce the value of the property regulated"); *Covington & Lexington Turnpike Rd. Co.* v. *Sandford*, 164 U.S. 578, 596 (1896) ("It cannot be said that a corporation is entitled, as of right, and without reference to the interests of the public, to realize a given per cent upon its capital stock.").

As this Court instructed another armada of California insurance companies: "Appellant's business may of course be less prosperous as a result of the regulation. That diminu-

tion in value, however, has never mounted to the dignity of a taking in the constitutional sense." *California State Auto. Ass'n v. Maloney*, 341 U.S. 105, 111 (1951).

There is simply no avoiding the fact that these Petitioners are asking the Court to pronounce that regulation may not diminish the value of a regulated firm. Such ambitions have not seriously been entertained since the demise of *Lochner v. New York*, 198 U.S. 45 (1905). Unless the Court is prepared to rediscover "Social Statics" in the Fourteenth Amendment, *id.* at 75 (Holmes, J., dissenting), it cannot entertain the constitutional theory Petitioners are concocting.

III. Petitioners Assume a Constitutional Entitlement to a Profit Level Individually Tailored for Each Regulated Firm.

In arguing that any rate of return less than the company's cost of capital is confiscatory, Petitioners make yet another fallacious assumption: that the Constitution entitles each firm whose rates are regulated to a profit hand-tailored to its individual circumstances. Of course, no case has ever even suggested such a notion.

Again, one must pause to consider how much settled law Petitioners would have this Court upset—a broad swath across the law of economic regulation that Petitioners nowhere acknowledge. At various times, numerous commodities are regulated by the states or the federal government—sometimes the whole economy. *E.g.*, *Amalgamated Meat Cutters & Butcher Workmen v. Connally*, 337 F. Supp. 737 (D.D.C. 1971) (upholding Pres. Nixon's wage- and price-controls). Often those laws merely specify a uniform price (or uniform maximum) that may be charged. May each participant in such a market breach the maximum price by showing that it needs a higher profit to match its cost of capital? To ask the question is to answer it.

For example, states routinely prohibit loans at usurious interest rates—rates typically expressed as a single maximum

percentage. Nobody has previously suggested a lender could pierce the usury laws by showing that it cannot earn a reasonable profit, given its unique circumstances, without charging a usurious rate. Many laws impose a single maximum price without creating a forum for adjudicating variances. To entertain Petitioners' argument is to suggest that all such garden-variety regulatory laws are unconstitutional.

Numerous cases have approved the imposition of flat or formulaic rates that need not be tailored to the circumstances of each regulated entity. Even when dealing with actual out-of-pocket expenditures—matters considerably more tangible and objective than an insurer's rate of return—agencies have long been authorized to impute to all regulated firms an average cost rather than taking the actual cost figures supplied by each company. *E.g.*, *Federal Power Comm'n v. Texaco Inc.*, 417 U.S. 380, 387-88 (1974); *Tagg Bros. & Moorhead v. United States*, 280 U.S. 420, 440-42 (1930); *Central Ark. Auction Sale, Inc. v. Bergland*, 570 F.2d 724, 728 (8th Cir. 1978).

The leading case is, of course, *In re Permian Basin Area Rate Cases*, 390 U.S. 747 (1968) ("*Permian*"), where this Court upheld the constitutionality of uniform area rates for natural gas producers. The Federal Power Commission set a single rate for gas producers in a given area, based on the average costs of all those producers. Each of the maximum area rates allowed a uniform authorized "return to the producer of 12 percent on average production investment." *Id.* at 761-62. The Court rejected the producers' arguments that the rigid *Permian* scheme was unconstitutional because it did not customize the rate for each producer, holding:

> This Court has repeatedly recognized that legislatures and administrative agencies may calculate rates for a regulated class without first evaluating the separate financial position of each member of the class; it has been thought

> to be sufficient if the agency has before it representative evidence, ample in quantity to measure with appropriate precision the financial and other requirements of the pertinent parties.

Id. at 769;[15] *see also South States Oil & Gas v. Federal Energy Reg. Comm'n*, 653 F.2d 1052, 1054 (5th Cir. 1981) ("So long as area rates fairly treat producers as a group, no producer can insist on a rate tailored to his own costs."); *Giles Lowery Stockyards* v. *Department of Agric.*, 565 F.2d 321, 327 (5th Cir. 1977).

IV. Petitioners' Claim Is Based on Evidence the Trier-of-Fact Rejected as Neither Credible Nor Persuasive.

One would expect a petitioner with such ambitions at least to come to this Court with a compelling evidentiary record to prove a cost of capital above the authorized rate of return. In fact, the trier of fact found the record bereft of *any* credible evidence of 20th Century's cost of capital.

In scores of pages of detailed findings adopted by Respondent Commissioner, the Administrative Law Judge

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[15]In *Permian* the FPC "acknowledged that area maximum rates derived from composite cost data might in individual cases produce hardship, and declared that it would, in such cases, provide special relief." 390 U.S. at 764. The only ground the FPC gave for such relief was when "'out-of-pocket expenses in connection with the operation of a particular well' exceed [the] revenue from the well under the applicable area price." *Id.* at 770-71 (citation omitted). The commission thereafter was steadfast in granting "special relief" only where the area rates did not permit the producer to recover its out-of-pocket costs. *E.g.*, *Federal Energy Reg. Comm'n v. Pennzoil Producing*, 439 U.S. 508, 515 (1979); *Dorchester Gas Producing v. Federal Energy Reg. Comm'n*, 571 F.2d 823 (5th Cir. 1978); *Southern La. Area Rate Cases v. Federal Power Comm'n*, 428 F.2d 407, 420 n.24 (5th Cir. 1970). The unbroken line of cases upholding rate orders that protect only out-of-pocket expenses—that leave *no profit* at all—demonstrates how far afield of established constitutional jurisprudence Petitioners' argument lies.

who heard the case reviewed 20th Century's "cost of capital" evidence and found it to be wholly unpersuasive. She noted that it was afflicted with methodological infirmities, (App. 295a), "inconsistencies, unsubstantiated and self-serving assumptions which drove [the] conclusions, implausible extreme positions," (App. 285a), wildly inconsistent findings, (App. 285a-286a), theoretical claims at odds with observed history, (App. 285a, 300a-301a), and a lack of candor in the testimony of the company's witness, (App. 301a n.29).

The Commissioner noted that measuring a property-casualty insurance company's "cost of capital" is always difficult and often fictional. Unlike the utility industry (where most of the cases cited by Petitioners arose), insurance companies only rarely raise funds in the capital markets. Two salient characteristics of the insurance business make that unnecessary: Insurers do not make large capital investments in plants and equipment (as do utility power plants), and insurers are paid by their customers before they have to incur most of the costs of the insurance business. Consequently, insurance companies typically meet their capital needs through internal growth, without having to sell equity or borrow cash. (App. 94a.) The Commissioner found it significant that none of the witnesses tendered by 20th Century and the other Petitioners has ever recognized these facts in their robotic application to the insurance industry of financial models designed to assess a firm's ability to raise capital in equity markets.

Under California law, a trier of fact such as an administrative agency is entitled to disbelieve even uncontradicted expert testimony it finds unpersuasive.[16] *E.g.*, *Leonoff v.*

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[16]California law is, in this respect, in accord with general principles of evidence. *See, e.g.*, *Bohus v. Board of Election Comm'rs*, 447 F.2d 821, 823 (7th Cir. 1971) ("The opinions of experts, even if uncontradicted, may be disregarded by the trier of fact"); 11 Jeremy C. Moore et (continued...)

Board of Supervisors, 222 Cal. App. 3d 1337, 1349, 272 Cal. Rptr. 372 (1990); *Newberry Springs Water Ass'n v. County of San Bernardino*, 150 Cal. App. 3d 740, 750, 198 Cal. Rptr. 100 (1984); *Brentwood Ass'n for No Drilling, Inc. v. City of Los Angeles*, 134 Cal. App. 3d 491, 504, 184 Cal. Rptr. 664 (1982); *cf. People v. Coogler*, 71 Cal. 2d 153, 166, 77 Cal. Rptr. 790, 454 P.2d 686 (1969); *People v. Bassett*, 69 Cal. 2d 122, 141, 70 Cal. Rptr. 193, 443 P.2d 777 (1968) ("chief value of an expert's testimony . . . rests upon the *material* from which his opinion is fashioned and the *reasoning* by which he progresses from his material to his conclusion . . . it does not lie in his mere expression of it"). Among the recognized grounds for disregarding uncontradicted testimony are the testimony's inherent improbability, internal inconsistencies and contradictions, lack of supporting facts, and the witness' demeanor on the stand. *See generally* 3 B.E. Witkin, *California Evidence* §§ 1751-1756 (3d ed. 1986). On each of these grounds, the Commissioner, on recommendation of the ALJ who heard the testimony, adopted findings fully explaining why the insurer's opinion testimony was being rejected.[17]

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[16](...continued)
al., *Moore's Federal Practice* ¶ 702.301[2] (2d ed. 1985) ("[t]he trier of fact may choose to believe little or none of the expert's testimony").

[17]The opinion of the superior court judge reversed by the California Supreme Court cannot, of course, supply the missing findings. The lower court judge found the Commissioner's rejection of 20th Century's evidence erroneous. (App. 201a-202a.) However, the judge's opinion was expressly predicated on a legal error: that the Commissioner could not rely on his rate-of-return regulation and his record and decision in adopting that regulation because they "were neither offered in evidence, nor judicially noticed." (App. 201a.) The record below reflects the fact that the material was, indeed, judicially noticed (and vigorously debated). (App. in Cal. S. Ct. at 14884.) Thus, the superior court's conclusion that "[t]here is no evidence in the [adjudicatory] record contradicting 20th Century's evidence, and thus no basis for rejecting it" was legally and
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Without a record to support 20th Century's lofty claims about its cost of capital, the petition amounts to nothing more than a request for an advisory opinion about what some other insurance company might achieve in some future case were it able to prove a high cost of capital.

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[17](...continued)
factually incorrect.

The error is illustrated by that court's treatment of the rulemaking record, where the court *upheld* the Commissioner's rejection of evidence precisely like that proffered by 20th Century in its company-specific hearing. (App. 190a-195a.) In his decision in the 20th Century case, the Commissioner cited his prior findings on the deficiencies of the insurers' rate-of-return evidence and observed that "20th Century has not attempted to explain why its evidence of the same type is not afflicted with the same infirmities." (App. 285a.) Remarkably, after crediting the analysis in the rulemaking record, the judge actually criticized the Commissioner's reference to that analysis in the 20th Century case, likening it to mere "'common knowledge and experience' about state of the economy" and an impermissible basis for an evidentiary finding. (App. 202a.)

In its summary of the superior court's decision, the California Supreme Court recited the lower court's flawed analysis. (App. 34a-42a.) Petitioners misleadingly describe this recitation of the decision as follows: "[T]he California Supreme Court expressly acknowledged that 20th Century's cost of capital 'was found to be at least 20 percent.' *Id.* at 116a." (Pet. at 18.) The California Supreme Court "acknowledged" nothing; it simply recited the superior court's erroneous conclusion. Because the issue of 20th Century's company-specific cost of capital was properly irrelevant under the regulations, *see supra* section III, p. 19, the California Supreme Court had no need to make any finding on 20th Century's cost of capital.

Having erroneously excluded the evidence of the deficiencies in the insurer's case, the superior court was unable to assess the basis for the Commissioner's finding the evidence deficient. The Commissioner's finding that 20th Century's evidence was unpersuasive remains unreviewed by the superior court and unaffected by the decision reversed by the California Supreme Court.

CONCLUSION

As Petitioners have shown, any rate order can be given a constitutional façade with liberal use of the word "confiscation." But as this Court has long held, the mere fact that a rate order "might affect property rights to some degree" does not mean each component of the order may "properly be characterized as having a constitutional dimension." *Duquesne Light Co. v. Barasch*, 488 U.S. 299, 310 (1989) (citing *Hope*, 320 U.S. at 602). For a half-century, from *Hope* and *Market Street Railway v. Railroad Commission*, 324 U.S. 548 (1945), to *Permian* and *Duquesne*, the Court has entrusted matters of economic regulation to expert administrative agencies and resisted efforts to transform economic doctrine to constitutional dogma.

The petition now before the Court, urging it to examine whether a one-year rate should have yielded a profit greater than the authorized 10%, is merely the latest such question of regulatory policy dressed in constitutional garb. The Court's settled jurisprudence holds this newest challenge to established law to be unworthy of certiorari. Respondent requests that the petition be denied.

Respectfully submitted,

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